

Growing Pains in Latin America



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Motivation

- Even in the good years of 2003 – 2007, when Latin America (and everybody else) was growing, the region's income per-capita gap relative to high income countries and other emerging-market economies widened and poverty remained stubbornly high.
- Increasing discontent among large segments of the population with the results of market-based reforms put the brakes on further reform efforts.

Questions

- What can individual Latin American countries do to accelerate economic growth while ensuring its sustainability?

And:

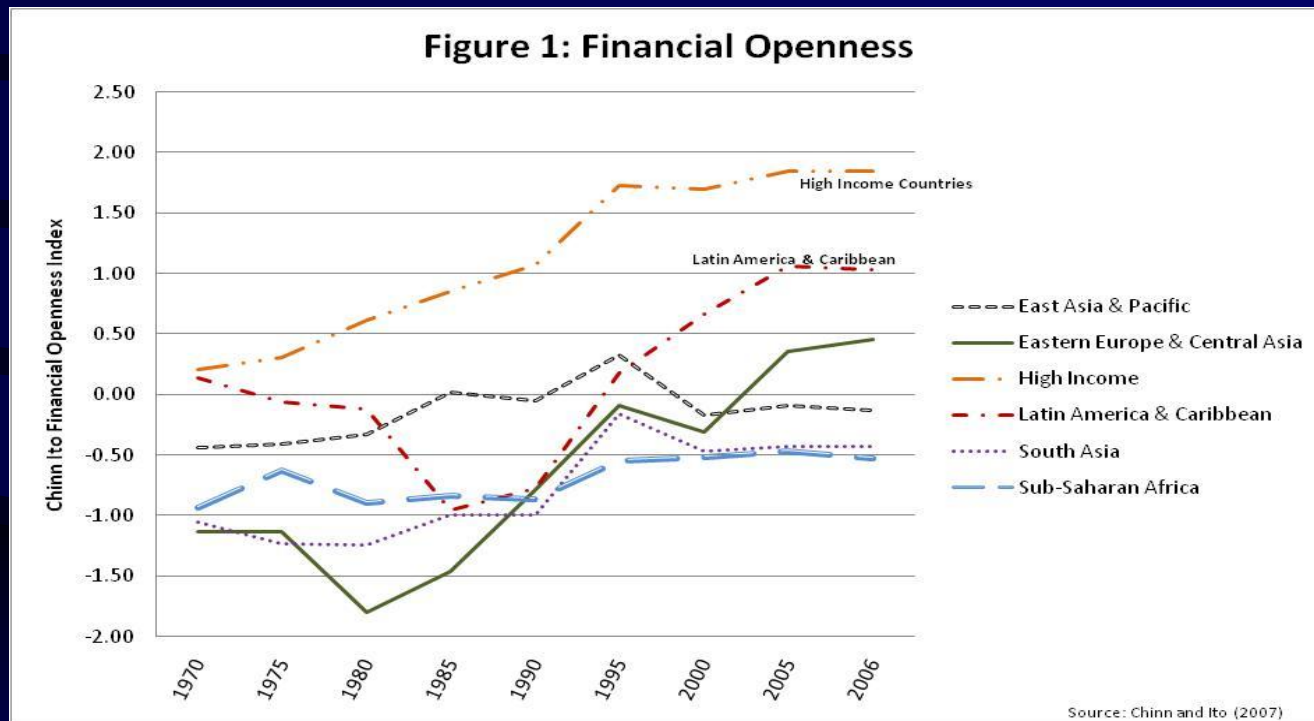
- How to tackle this complex issue, given that the region has already undertaken a significant number of reforms and policies?

By developing and applying a straightforward and simple analytical framework especially designed for Latin America

Understanding Latin America

Three features distinguish Latin America from other developing regions of the world:

I. IT IS THE MOST FINANCIALLY OPEN

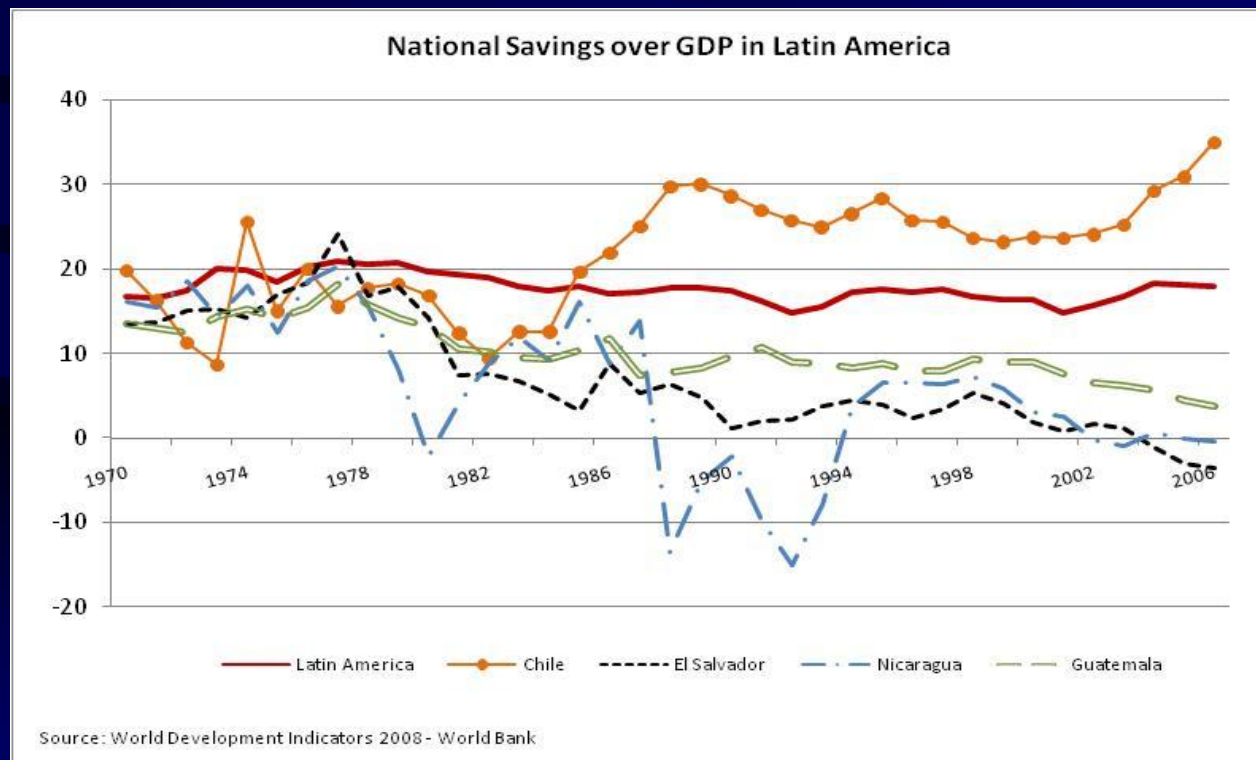


- The emphasis on capital account liberalization began in the late 1980s with the introduction of the Brady Plan
- Financial Openness has increased both the region's financing capacity and its vulnerability to developments in international capital markets.

Understanding Latin America

I. IT IS THE MOST FINANCIALLY OPEN

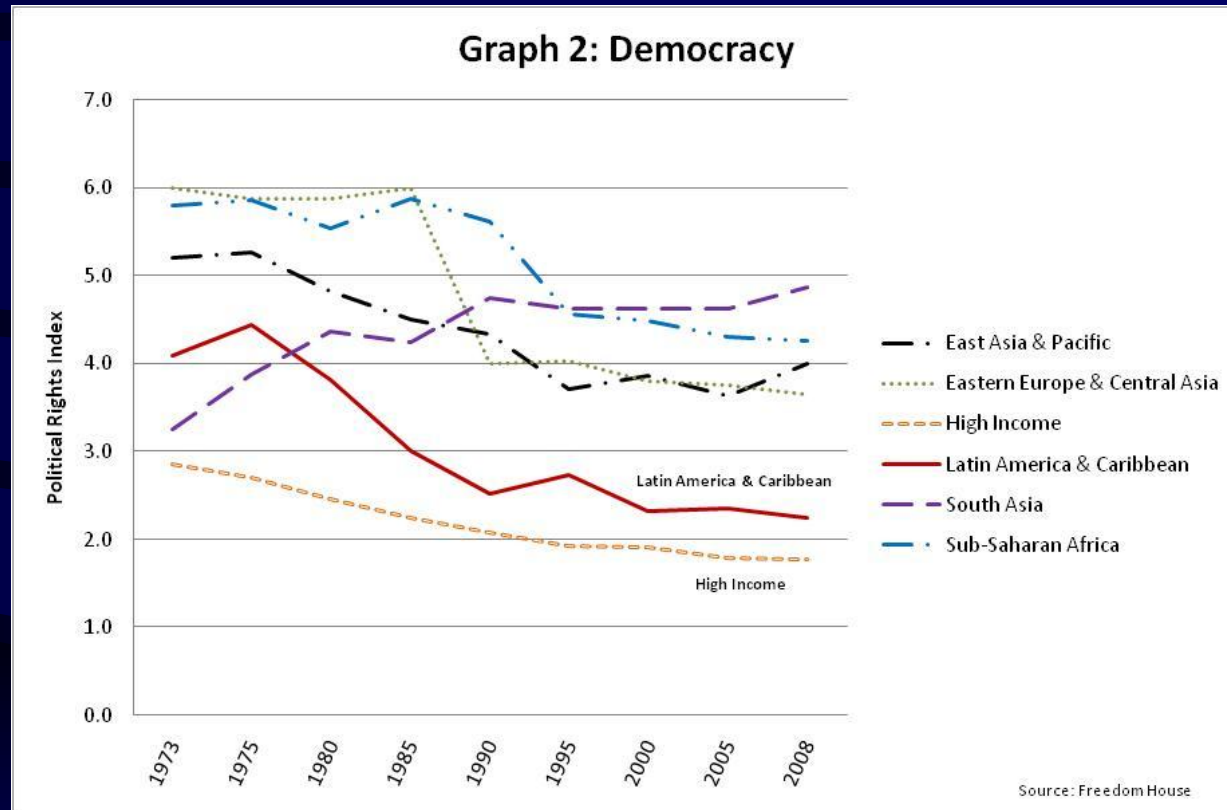
- With the exception of a few countries (most notably Argentina, Ecuador and Venezuela), capital controls have not been in the policy agenda (not even in the peak of the crisis).
- The fundamental reason: national saving rates have remained extremely low.



Open capital accounts in Latin America are here to stay

Understanding Latin America

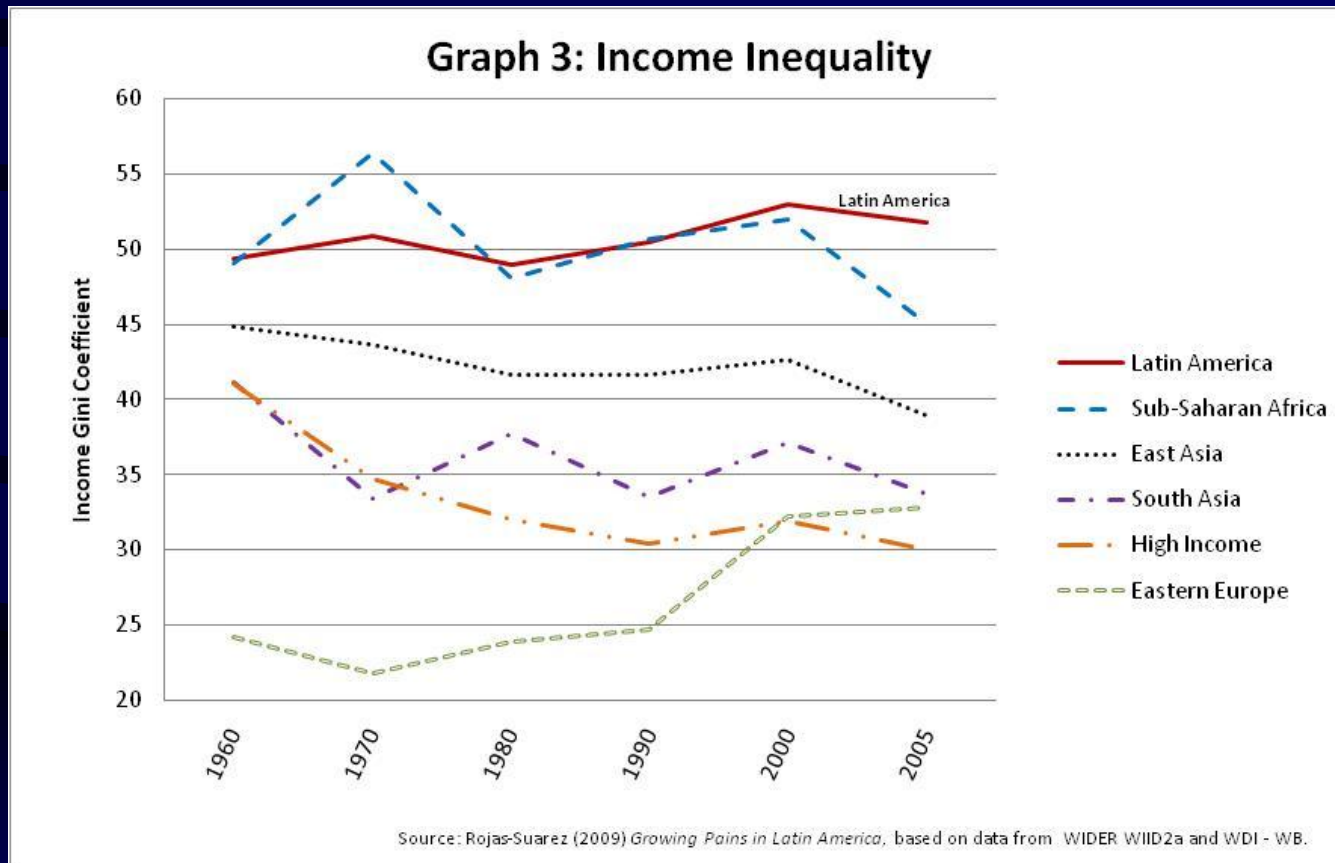
II. LATIN AMERICA IS THE DEVELOPING WORLD' MOST DEMOCRATIC REGION



- This implies that pro-growth reforms might prove unsustainable if the reforms' benefits don't reach a large proportion of voters...
... and explains discontent with the market economy and the election of several "leftist" Presidents.

Understanding Latin America

II. LATIN AMERICA HAS THE WORLD'S MOST UNEQUAL DISTRIBUTION OF INCOME



Evidence indicating a negative relationship between inequality and the reform process in Latin America might be related to the unique combination of the region being the most democratic and the most unequal.

An Analytical Framework for Growth in Latin America

- All growth frameworks seek to identify the main foundations that encourage the accumulation of physical and human capital as well as improvements in technology.
- A contribution of this book is that foundations are identified by taking into account the specific features of Latin America.

The Growth Foundations

The high degree of financial openness of Latin America indicates that the region has chosen to allow market forces, through the behavior of the international capital markets, to assess the performance of their economies.

Thus, the first basic foundations are those that create incentives for the appropriate functioning of markets:

- 1) *Secure property rights* so that individuals and firms can benefit from their investment.
- 2) *Sufficiently equal opportunities* to level the playing field by lowering barriers to entry to allow individuals and firms without political connections or large wealth to succeed.
- 3) *Sufficient economic and political competition*, to avoid capture of state by powerful elites.

The Growth Foundations

But the sustainability of market-based growth in the context of financial openness requires as a fourth foundation:

- 4) *Macroeconomic Stability* without which the ability of any other policies and reforms to deliver growth would be severely curtailed because of the region's vulnerability to deterioration in investors' perceptions.

The Growth Foundations

- A fifth foundation arises out of the need to reconcile market-based reform with the discontent of large segments of the population regarding the functioning of the market system.
- The region's unique combination of being the most democratic and the most unequal implies that a necessary growth foundation is:
 - 5) *Broad sharing of benefits from growth* to allow for sustainable market-based reforms backed by population support.

Can Reforms Impact the Growth Foundations?

Reform	Property rights	Equal opportunity	Competition	Macroeconomic stability	Broad sharing of growth benefits
Trade		✓	✓✓	?	?
Financial	✓	✓	✓	✓✓	✓
Labor	✓	✓✓			✓
Pension	✓	✓✓		✓✓	?
Privatization with regulation ^b	✓	✓		✓	✓
Budgetary institutions		✓	✓	✓✓	✓
Education ^c		✓		✓	✓✓
Fiscal Decentralization	?	?			✓✓
Tax reform	?	✓	✓	✓	✓
Judiciary	✓✓	✓	✓	✓	✓
Electoral process		✓	✓	✓	✓
Legislative	✓	✓	✓	✓	✓
Anti-corruption	✓	✓	✓	✓	✓

- A literature review says Potentially YES
- In practice, however, this has not always been the case.

Applying the Framework to Five Case Studies:

Countries	Foundations				
	Property Rights	Equal Opportunities	Economic and Political Competition	Macroeconomic Stability	Broad Sharing of Benefits of Growth
Brazil	W	S	S	W	N
Colombia	S	S	S (econ)	W	N
Costa Rica	S	W	S (econ)	NC	W
Mexico	W	W	W	NC	W
Peru	W	NC	S (econ)	S	W

Note: S = Strengthen, W = Weakened, N = Neutral, NC = Not clear

Competition

- Economic (although not necessarily political) competition strengthened all countries but Mexico.

Ex: **Brazil:** regulations limiting entry and competition were eliminated (such as price controls)

Costa Rica: trade liberalization shifted the country's comparative advantage from land to human capital, increasing competition for human resources.

Brazil, Costa Rica and Peru: break-up of some (not all) public monopolies.

Macroeconomic Stability

- Only the study on **Peru** strongly concludes that this foundation was strengthened by the reforms.
 - This conclusion is based not only on current macro indicators but also on the overall economic and political infrastructure that supports the sustainability of adequate macro policies.
- Ex: In **Brazil** and **Colombia**, excessive state and/or judicial activism risk the sustainability of the macro stance.

Broad Sharing of the Benefits from Growth

Identified as the “missing foundation”

Ex: **Peru**: although income inequality has decreased at the national level, urban-rural disparities have increased.

Costa Rica: downsizing the public sector lacked priorities and affected government branches most important for broad sharing of growth: education, public infrastructure and social assistance

A Sample of Proposals

BRAZIL

Reform of the judicial system to *secure property rights* (reduce contracts breached and ruling delayed by politically – motivated judges):

- Adopt performance indicators for promoting judges
 - indicator: percentage of a judge's decisions confirmed on appeal
- Index judicially-imposed obligations to the SELIC to reduce financial incentive to delay final court rulings
- Raise public awareness of the consequences of poor judicial performance for development and social equity.

A Sample of Proposals

COLOMBIA

Curtail the ability of the Constitutional Court to tamper with economic matters in general and with *macroeconomic stability* in particular:

- Reduce politization of court magistrates by allowing them to run for a second term, after a cool-off period.
- Seek consensual definition by all powers of what constitutes an adequate health care plan and other social services to avoid discretionary provision of services by court ruling.
- Implement a process by which the court reviews laws as soon as they are approved (rather than reversing them after they have become operational)

A Sample of Proposals

COSTA RICA

Reform the Legislative System to enhance *all* growth foundations, but particularly the *broad sharing of the benefits of growth* (to deal with the reform paralysis of Congress resulting from the blockage of a minority anti-reform party)

- Set deadlines by which the congress must vote on proposed laws.
- Grant the Executive some power to declare certain bills urgent, to shorten the decision time (a practice followed in Chile)
- Require congressional quorum for votes and not for debate
- Change procedures to speed up representatives' actions (put forward their positions, place them on record and propose amendments)

A Sample of Proposals

MEXICO

Reform *competition* policy

- Grant full autonomy for the Federal Competition Commission to avoid capture by other government agencies.
- Creation of specialized courts in competition and regulatory cases to minimize delays in executing the law.

A Sample of Proposals

PERU

Reforms of the State are essential to deal with the lack of implementation capacity that limits the sharing of benefits from growth.

- Introduce a merit-based career path for new public servants
- Program budgetary expansions in a result-based format
- Consolidate small regional governments (geographic units) into fewer, large ones.

A Reason for Optimism

The proposed reforms are doable, recognize the need for “incremental” rather “big bang” reforms and focus on persuasion and collaboration rather than top-down imposition of policies

Some of the proposals are being implemented:

- In **Peru** a National Authority for improving civil service was created
- In **Mexico** the Executive will shortly present to congress a reform proposal granting greater independence to the Competition Commission
- In **Costa Rica**, the chapter authors are writing the Economic Program of Presidential Candidate Laura Chinchilla